CHAPTER 21

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SUPPORTING MARKET INTEGRITY

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> "An integrated and efficient financial market requires market integrity. The smooth functioning of securities markets and public confidence in markets are prerequisites for economic growth and wealth. Market abuse harms the integrity of financial markets and public confidence in securities and derivatives." (Directive 2003/6/EC (Recital 2)). x

I. INTRODUCTION

Concerns about the integrity of financial markets are as old as financial markets themselves. Practices such as market manipulation, perpetrated through the spread of false rumours, were widely reported in and around the time of the South Sea Bubble[1] – as, indeed, was the practice of insider dealing.[2] More recently, events surrounding the worst financial crisis since the Wall Street Crash have, if anything, served to intensify interest in and scrutiny of the integrity of financial market activity.[3] Allegations of the

[1] See R Dale, *The First Crash: Lessons from the South Sea Bubble* (Princeton University Press, 2004) 17–19, and sources cited therein.
[2] See, for example, J Narron and D Skeie, "Crisis Chronicles: The South Sea Bubble of 1720—Repackaging Debt and the Current Reach for Yield" (http://libertystreeteconomics.newyorkfed.org/2013/11/crisis-chronicles-the-south-sea-bubble-of-1720repackaging-debt-and-the-current-reach-for-yield.html) (noting the conduct of Sword Blade Bank in events predating the "bubble").
[3] "Market integrity" is defined by the International Organisation of Securities Commissions (IOSCO), as "the extent to which a market operates in a manner that is, and is perceived to be, fair and orderly and where effective rules are in place and enforced by regulators so that confidence and participation in the market is fostered": *Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency* (Final Report of the Technical Committee of IOSCO, October 2011, available

opportunistic shorting of stock in the immediate aftermath of the crisis,[4] claims of hedge fund involvement in insider dealing,[5] ongoing concerns about the manipulation of benchmarks,[6] and mounting fears over the use of certain High Frequency Trading (HFT) strategies,[7] all underscore the acute sensitivity of both market and public opinion to practices which call into question the integrity of financial market transactions.

At its broadest, this chapter seeks to chart major shifts – both academic and regulatory – in relation to on-going debates about the need for measures which seek to protect the integrity of our financial markets. Although the discussion is designed to be global in its reach, the material discussed draws primarily on developments in the EU and US – and to a lesser extent the UK – and focuses on market integrity issues associated with insider dealing and market manipulation (collectively hereinafter, "market abuse").

It is suggested, that the picture which emerges from this survey is as following: first, that the evolving nature of financial markets – in particular, the growing complexity and fragmentation of markets as a result of the proliferation of trading across different venues and

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at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD361.pdf)) (9) (hereinafter IOSCO, *Regulatory Issues* (2011)).

[4] See below n 17 and accompanying text.

[5] For a review of the Securities and Exchange Commission (SEC) efforts in the US, see, L Thomsen, D Hawke, and P Calande, "Hedge Funds: An Enforcement Perspective" (2008) 39 *Rutgers LJ* 541, 577–593. For similar concerns in the UK pre-crisis, see, FSA, *Hedge Funds: A Discussion of Risk and Regulatory Engagement* (Discussion Paper 05/04) 53; and, within the EU, see, N Naik, *Hedge Funds: Transparency and Conflict of Interest* IP/A/ECON/IC/2007-24 (http://www.europarl.europa.eu/RegData/etudes/etudes/join/2007/393519/IPOL-ECON_ET(2007)393519_EN.pdf) 30–32.

[6] See generally FSA, *Annual Report* 2012/13.

[7] IOSCO, *Addendum to IOSCO Report on Investigating and Prosecuting Market Manipulation* (April 2013) 1 (available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD411.pdf. See also, IOSCO, *Regulatory Issues* (2011) above n 3, 48.

developments associated with HFT strategies[8] – has made it more difficult for regulators to monitor for possible cases of market abuse. Furthermore, these developments have not only increased the risk that new variants of market manipulation will emerge, but have afforded opportunities for the use of abusive practices on a scale not previously possible.

Secondly, although the academic debate with regard to the merits or otherwise of one prominent form of market abuse – insider dealing – remains as alive as ever, there are signs of a shift in the nature of this debate, away from earlier exchanges rooted in clashes between competing theoretical viewpoints, towards one which today focuses on an empirical analysis of the effects of regulation and its enforcement.

Thirdly, from a policy-making/regulatory perspective, there are clear signs of an evolving regulatory landscape characterised by expansionist tendencies. This reflects a shift away from the need to justify why market abuse should be regulated under law, towards an emphasis on identifying where, in the wake of changing market structures and the emergence of new strains of market abuse, the appropriate boundaries of market abuse offences ought to lie. Reform of the EU's market abuse regime offers an ideal vantage point from which to review this shift. What is more, a discussion of the position within the EU – at least from the perspective of the regulation of insider dealing – offers an interesting and important counterpoint to the increasingly anomalous approach adopted in the US.

[8] HFT is strongly associated with algorithmic trading, in that it is a highly quantitative. However, speed of execution and a high daily portfolio turnover and high order to trade ratio (ie a large number of orders are cancelled in comparison to trades executed) are regarded as key characteristics distinguishing it from other forms of algorithmic trading.

Finally – and to some extent resonating with EU reforms in relation to enforcement concerns – there is evidence of global trend towards more active enforcement of market abuse, spearheaded in the main by developments in the US and the UK, most significantly in relation to the use of criminal sanctions as a deterrent for insider dealing.

In presenting and developing these ideas, the structure of the chapter is as follows. In section II, I set the scene by identifying the types of conduct/activity which gives rise to market integrity concerns, following which I discuss the likely incidence of market abuse in modern financial markets. In Section III, I assess the claimed rationales for prohibitions on market abuse and present and, subsequently, critique new empirical research which – in the context of insider dealing at any rate – claims to support prohibitions on efficiency grounds. In section IV, I survey the evolving regulatory landscape. Although the focus here is on the EU's market abuse regime and recent attempts to remodel its contours, I contrast aspects of the EU' evolving regime with developments in the US – principally, in relation to the regulation of insider dealing. In section V, I focus on enforcement issues, and, finally, in section IV, I draw out key stands of the discussion and present my conclusions.

II. CONDUCT WHICH RAISES MARKET INTEGRITY CONCERNS AND THE INCIDENCE OF MARKET ABUSE

Conduct Which Raises Market Integrity Concerns

Activity which gives rise to market integrity concerns encompasses a wide spectrum of conduct ranging from "classic" insider dealing (ie dealing on inside information – as well as encouraging others to deal, or disclosing inside information to others)[9] to various forms of market manipulation. These manipulations themselves cover a wide spread of activities,[10] such as the use of false statements designed to "move" the market in a particular direction (so-called "pump and dump" schemes), and the deployment of "artificial" devices devoid of any "substantive economic purpose"[11] and designed merely to create a false impression of market activity.[12] Such devices include "wash trades";[13] "improper matched orders";[14] "pools";[15] and so-called "painting the tape".[16] The underlying aim of all these schemes is to generate profits or avoid losses by inducing investors to purchase securities which subsequently turn out to have little – or no – marketability or value.

[9] From a regulatory perspective, this involves trading in the relevant securities in *public* markets.

[10] Commentators often distingish between transaction based manipulations (such as transactions involving ficititious devices) and information based manipulations (such as disseminating false or misleading information). See, eg, G Ferrarini, *The European Market Abuse Directive* (2004) 41 *Common Market Law Review*, 724– 28; and

[11] D Donald, "Regulating Market Manipulation through an Understanding of Price Creation" (2011) 6 *NTU L Rev* 55, 68.

[12] See, *Palmer's Company Law* (Sweet & Maxwell: Looseleaf) para 11.146; D Fischel and D Ross, "Should the Law Prohibit 'Manipulation' in Financial Markets?" (1991) 105 *Harvard Law Review* 503, 504; FCA Handbook, Market Conduct (MAR 1.6.2E); and Committee of European Securities Regulators (CESR), *Market Abuse Directive: Level 3 - first set of CESR guidance and information on the common operation of the Directive* (CESR/04-505b) (http://www.esma.europa.eu/system/files/04_505b.pdf) (hereinafter, CESR Guidance).

[13] Where there is no change in the beneficial ownership of the underlying securities other than between the parties acting in concert.

[14] Where matching buy and sell orders are entered into simultaneously by colluding parties.

[15] Where groups of investors trade amongst themselves in order to suggest an active market in the underlying financial instruments.

[16] Where colluding parties entering into a series of transactions shown on a public display facility.

Other manipulations include the misuse of market power by way of so-called "corners" (which involve, first, building up and, subsequently, manipulating a controlling or dominant market position),[17] or "abusive squeezes" where a person with significant influence over the supply of a security restricts its liquidity in order to create a price "spike".[18]

More recently, in the wake of the financial crisis, regulators saw fit to intervene to prohibit – by way of temporary measures – what was widely viewed as abusive short selling in vulnerable financial institutions. Both the SEC, in the US, and the now-defunct FSA, in the UK, were at the forefront of orchestrating these temporary bans. Broadly, the measures prohibited the active creation or increase of net short positions in the securities of vulnerable financial sector companies and required market disclosure of significant short positions in these securities.[19] Following these interventions, regulators were again forced to take action against leading financial institutions in relation to the manipulation of the London Inter-Bank Offered Rate (LIBOR),[20] and, in recent months, allegations

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[17] MAR 1.6.4E(1).

[18] MAR 1.6.4E(4); CESR Guidance, above n 12, 12; and P Wood, *Law and Practice of International Finance* (Sweet & Maxwell, 2008, University Edition) paras 24-04 –24-12.

[19] See generally, FSA, *Short Selling* (DP 09/1) and J Payne, "the Regulation of Short Selling and its Reform in Europe" (2012) 13 *European Business Organization Law Review* 413.

[20] See generally, *The Wheatley Review of Libor: Final Report* (September, 2012) (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/191762/wheatley_review_libor_finalreport_280912.pdf). Notwithstanding the importance of LIBOR, the benchmarks upon which it is based did not fall *directly* within either the EU's or the UK's market abuse regimes. Forthcoming reforms to the EU regime – see Section IV below – will remedy this deficiency. For recent reforms in the UK, see Financial Services Act 2012, s 91(which makes the manipulation of financial benchmarks a criminal offence). The LIBOR scandal underscores the need for concepts of market abuse which are "sufficiently flexible to meet the challenges of new technologies for communication and trading". *Palmer's Company Law*, above n 12, para 11.146.

have also surfaced of similar manipulation in relation to the Euro Inter-Bank Offered Rate (EURIBOR).[21]

Unsurprisingly, in the aftermath of the financial crisis, a renewed emphasis on market integrity has also become evident at the global level. In its November 2010 Seoul Communiqué, the G20 leaders tasked the International Organisation of Securities Commissions (IOSCO) with developing recommendations to promote market integrity, especially in the context of "risks posed to the financial system by … technological developments."[22] According to IOSCO, although traditional forms of market manipulation remain a ongoing feature of financial markets, the evolving nature of these markets – in particular, the increasing range of venues on which financial products are traded in tandem with the growth of HFT strategies (which are highly quantitative and focus on speed of execution, high daily portfolio turnover, and a high order to trade ratio) – poses significant challenges for regulatory authorities.[23] Abuses which have become a particular focus of attention in the context of HFT strategies include:[24]

> "Momentum ignition" – where a series of orders and trades are initiated in an attempt to set trends and foster rapid price movements;

[21] "JPMorgan, "HSBC and Credit Agricole accused of euro rate-fixes" (http://www.bbc.co.uk/news/business-27482358 (20 May 2014)).
[22] *The G20 Seoul Summit Declaration*, 11-12 November 2010, available at http://www.g20.utoronto.ca/2010/g20seoul-doc.pdf.].
[23] Above n 7.
[24] See, eg, IOSCO, *Regulatory Issues*, above n 3, 30; and the European Securities and Markets Authority (ESMA), *Guidelines: Systems and Controls in an Automated Trading Environment for Trading Platforms, Investment Firms and Competent Authorities* (24 February 2012, ESMA/2012/122 (EN)) (www.esma.europa.eu/system/files/esma_2012_122_en.pdf) (16-17) (hereinafter, ESMA Guidelines).

"Quote-stuffing" – where markets are flooded with an excessive number of orders which traders place, and then subsequently cancel, to cause uncertainty in the market;

"Spoofing" – where bids or offers are made with the intention that they will be cancelled in advance of execution;

"Layering" – where a trader enters several orders (which are subsequently cancelled) with the underlying aim of improving the price of a trade in the opposite direction; and

"Marking the close" or "banging the close" – where trading activity takes place either before or during the close of trading with the aim of impacting on settlement prices.

Although such practices are not new, in combination with the proliferation and fragmentation of the markets on which financial instruments are today traded, opportunities for abuse now exist on a scale not previously possible.[25]

Estimating the Incidence of Market Abuse

Given the illegal and secretive nature of market abuses, it is has proved difficult to ascertain the degree to which market abuse occurs in practice.[26]

With regard to insider dealing, in view of the potential for individual financial gain, the difficulties associated with regulatory detection, and, at least historically, the relatively remote likelihood of sanctions (even where

[25] According to the IOSCO, HFT more than doubled to as much as 56% of US equity trading in the period from 2005 to 2010. Similarly, in Europe, HFT increased form only 9% of equity trading in 2007 to 38% in 2010: *Regulatory Issues* (2011) above n 3, 23.
[26] Though detection rates are not unimportant, the number of people who commit market abuse which goes undetected is simply unknowable.

enforcement has followed successful detection), there are clearly strong incentives for individuals to engage in abuse. This is especially so ahead of a proposed takeover bid, where studies in the UK have routinely revealed abnormally high pre-announcement price movements (APPMs).[27] Similarly, in a recent US study by Beny and Seyhun, pre-takeover announcement spikes in stock prices were found to be 50% higher between 2006-2011 than in the pre-2006 period studied.[28] In research cited by the European Commission, involving an analysis of insider trading across ten international markets, it was estimated that insider dealing profits account for between 0.01 and 0.05% of total market turnover.[29] Furthermore, the European Commission estimates that profit gained from insider dealing in the EU's three largest exchanges – Euronext, Deutche Börse, and the LSE Group – expressed as a percentage of market turnover was 0.0356% in the period 2003-2009 and 0.0357% in 2009.[30]

In relation to other abusive practices, again reliable indications of the prevalence of abuse are unavailable. According to IOSCO's recent study identifying HFT as a particular area of concern, although no "clear evidence of the systematic and widespread use of abusive practices by those engaging

[27] In the UK, see the FSA, "Market Cleanliness" surveys, regularly referenced in FSA Annual Reports. The surveys focus only on insider dealing and not other forms of abuse.
[28] L Beny and N Seyhun "Has Illegal Insider Trading Become More Rampant in the United States? Empirical Evidence from Takeovers" in S Bainbridge (ed) *Research Handbook on Insider Trading* (Edward Elgar Publishing Ltd., 2013) 211, **000**.
[29] Capital Markets CRC Limited, *Enumerating the Cost of Insider Trading* (unpublished, 2010) 8, cited in European Commission, *Staff Working Paper Impact Assessment* SEC(2011) 1217 final) 16 (hereinafter, Commission, *Impact Assessment*). See also, C Comerton-Forde and T Putnins, *The prevalence and underpinnings of closing price manipulation,* (manuscript at 3) (April 28, 2010), *available at* SSRN: http://ssm.com/abstract-1243042 (suggesting that manipulation is a serious issue for exchanges); and, A Khwaja and A Mian, "Unchecked Intermediaries: Price Manipulation in an Emerging Stock Market" (2005) 78 *J Fin Econ* 203 (suggesting that "pump and dump" practices by institutional broker-dealers are particularly prevalent in developing countries).
[30] Commission, *Impact Assessment*, ibid., 200.

in HFT" was found, the report nevertheless recognised that "the submission of large numbers of orders and trades across multiple venues" poses significant challenges for national authorities.[31] Moreover, a growing number of recent cases in both the US and the UK involving manipulative conduct associated with HFT, is suggestive of an emerging problem.[32]

According to the European Commission, since the cost of market manipulation is likely to be of the same order of magnitude as insider dealing, it has been suggested that market abuse amounts to a combined cost of 0.0712% of market turnover.[33] Extrapolating this to the European equity market in 2010, the Commission claims that the total value of market abuse (ie insider dealing and market manipulation) in terms of market turnover, was in the region of EUR 13.3 billion – a figure which the Commission considers to be an underestimate of the total cost of abuse on all EU markets, since it is based only on an assessment of equity markets.[34]

[31] IOSCO, *Regulatory Issues* (2011), above n 3, 30. Moreover, as IOSCO recognises, in view of the growth in and relatively low level of scrutiny over OTC activity, these markets may "provide the ideal test markets for the development and refining of manipulative practices": IOSCO, *Addendum*, (2013) above n 7, 2.

[32] *In re Bunge Global Markets, Inc* (http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfbungeorder032211.pdf); *SEC v Hold Brothers Online* (http://www.sec.gov/litigation/admin/2012/34-67924.pdf); and *In the Matter of Panther Energy Trading LLC and Michael J Coscia* (CFTC Docket No 13–26) (22 July, 2013) http://online.wsj.com/public/resources/documents/pantherorder072213.pdf; *7722656 Canada Inc & Anor v The Financial Conduct Authority & Ors* [2013] EWCA Civ 1662.; and FCA, "FCA fines US based oil trader US $903K for market manipulation" (July, 2013) (http://www.fca.org.uk/news/fca-fines-us-based-oil-trader).

[33] Commission, *Impact Assessment*, above n 29, 200 (and studies cited therein).

[34] Interestingly, other studies reveal that irrespective of the real level of market abuse, market players *perceive* market abuse to be a widespread problem. For example, in the CFA's *Global Market Sentiment Survey: 2014*, survey participants identified market fraud (which the survey associated with conduct such as insider dealing) as the second most

III. A CRITICAL ASSESSMENT OF THE RATIONALES FOR REGULATING MARKET ABUSE

Market Manipulation

Although attempts to justify prohibitions on market manipulation – or, at least, certain species of it – have not gone unchallenged,[35] in general legal controls directed at market manipulation have provoked less heated debate than attempts to justify prohibitions on insider dealing.[36] It is widely asserted, for example, that market manipulation amounts to an "unwarranted" interference in the operation of ordinary market forces of supply and demand which undermines the "integrity" and efficiency of the market. [37] Not surprisingly defining what amounts to "unwarranted" conduct is not without difficulty. It is, of course, widely accepted that deliberately making false statements in order to "move" the market is objectionable, since fraud infringes notions of perfect, or competitive, markets – and, thus, is said to represent an impediment to market

serious issue facing their *local* markets, and the most serious ethical issue facing *global* markets. <http://www.cfainstitute.org/about/research/surveys/Documents/gmss_2014_whitepaper_print.pdf > 20.

[35] For claims that the law on market manipulation lacks conceptual and definitional clarity, see: Fischel and Ross, above n 12. The authors argue that there exists no objective definition of manipulation and that in so far as manipulation is objective it can be dealt with by the law against fraudulent conduct independently of any need to define it in securities law.

[36] In fact criticism has focused on deficiencies in the formulation or legal rules. See, eg, Donald, above n 11, 58–60.

[37] See, for example, IOSCO, *Investigating and Prosecuting Market Manipulation* (May, 2000) (price should be "set by the unimpeded collective judgment of buyers and sellers") 8; *North v Marra Developments Ltd* [1982] 56 AJLR 106, NSW CA (noting the importance of markets which reflect "the forces of genuine supply and demand" (*per* Mason J)); and N Moloney, *EC Securities Regulation* (2nd edn, 2008, OUP) 931 and sources cited therein.

optimality.[38] However, there is a risk that in seeking to prohibit market manipulation, legal rules that are broadly or vaguely framed will impede otherwise legitimate activities which promote price discovery and increase aggregate wealth. Similarly, definitional problems associated with "artificial" transactions and the "misuse" of market power, raise the spectre of regulatory over-reach and risk discouraging market innovations – again with adverse effects on wealth creation.

At first glance, characterising market manipulations as incidents of "market failure" provides an elegant framework within which to justify regulatory intervention so as to restore market equilibrium. However, on closer inspection, market failure analysis merely serves to camouflage what is ultimately at stake: the determination of which informational advantages are legitimate in the context of market exchanges. As will be explored more fully below in relation to the empirical debate over the merits or otherwise of insider dealing, this is a problem which is not capable of being resolved by way of an appeal to market efficiency, or by the use – as some have suggested – of a cost-benefit analysis as means of determining where to draw the line.[39]

Insider Dealing

In contrast to the more muted critiques of regulatory prohibitions on market manipulation, the debate regarding the merits or otherwise of insider dealing has generated a voluminous academic literature,[40] much of

[38] R Clark, *Corporate Law* (Little, Brown, 1986) 151.
[39] For example, as Clark claims, where to draw the line depends ultimately "on an assessment of the costs and benefits." Ibid, **000.**
[40] Henry Manne's 1966 book, *Insider Trading on the Stock Market*, (Free Press, New York, 1966), hereinafter "*ITSM*", remains, however, the *locus classicus*.

it sceptical of the "narratives" advanced in support of regulation,[41] and some – such as Carlton and Fischel's influential 1983 Stanford Law Review article – even suggesting that that the desirability of regulating the practice is, ultimately, an "empirical question".[42]

Justifications typically articulated to support such controls range from claims that insider dealing jeopardizes the development of fair and orderly markets, and, in so doing, undermines investor confidence;[43] that it is immoral,[44] and contrary to "good business ethics";[45] that it hurts corporations (and their shareholders),[46] as well as investors generally[47] and market-makers in particular;[48] and that it impairs the allocative efficiency of the financial markets,[49] by distorting managerial incentives with regard to disclosing information,[50] reducing market liquidity,[51] and increasing the cost of capital.[52]

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[41] J Benjamin, "The Narratives of Financial Law" (2010) 30 *OJLS* 787, 809.

[42] W D Carlton and D R Fischel, "The Regulation of Insider Dealing" (1983) 35 *Stanford Law Review* 857, 866 and 873. See also, F Easterbrook, "Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information" [1981] *Supreme Court Review* 309, fn 120 ("[a]lthough I think it likely that legal restrictions on [insider] trading are beneficial, the questions ultimately are empirical").

[43] Directive 2003/6/EC (hereinafter "MAD), Recital 2.

[44] See, K L Scheppele, "'It's Just Not Right': The Ethics of Insider Trading" (1993) 56 *Law and Contemporary Problems* 123; W Allen, "Professor Scheppele's Middle Way: On Minimizing Normativity and Economics in Securities Laws" (1993) 56 *Law and Contemporary Problems* 175; and R Schotland "Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market" (1967) 53 *Virginia Law Review* 1425, 1438–1439.

[45] See, eg, Justice, *Report on Insider Trading* (London, 1972) para 3.

[46] See, eg, R J Haft, "The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation" (1982) 80 *Michigan Law Review* 1051, 1051–1064.

[47] See, eg, W Wang, "Trading on Material Non-public Information on Impersonal Markets: Who is Harmed and Who can Sue Whom under SEC Rule 10b-5?" (1981) 54 *Southern California Law Rev* 1217, 1234–235.

[48] See, C A E Goodhart, "The Economics of 'Big Bang'" (1987) Summer *Midland Bank Review* 6, 10.

[49] See generally, M Klock, "Mainstream Economics and the Case for Prohibiting Inside Trading" (1994) 10 *Georgia State University Law Review* 297.

[50] See, Schotland, above n 44, 1448–1449.

By contrast, those who oppose regulatory controls on insider dealing claim that the rationale, method, and scope of such regulation are misconceived. Specifically, it has been contended that inside information is a property right belonging to the firm, which the firm should be free to allocate as it sees fit;[53] that insider dealing is an effective means of compensating entrepreneurs and managers;[54] that, rather than hindering accurate price formation, insider dealing actually helps to promote it[55] – by providing a less costly means of channelling information about securities into financial markets,[56] and by helping to smooth out undesirable market fluctuations.[57] In doing so, insider dealing is said to help improve the efficiency of markets, both informationally and, by extension, allocatively.[58] What is more, it has also been claimed that neither corporations (or their shareholders),[59] nor investors generally,[60] or market makers in particular,[61] are hurt by the use of inside information; and, finally, it has even been

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[51] See, Klock, above n 49, 330.

[52] See, M Mendelson, "Book Review: The Economics Board of Insider Trading Reconsidered " (1969) 117 *University of Pennsylvania Law Review* 470, 477–478; and V Brudney, "Insider, Outsiders, and Informational Advantages Under Federal Securities Laws" (1979) 93 *Harvard Law Review* 322, 355–356.

[53] See generally, J Macey, *Insider Trading: Economic, Politics, and Policy* (AIE Press, Washington DC, 1991).

[54] See, Carlton and Fischel, above n 42, 866–872; Macey, above n 53, 000.

[55] See, Carlton and Fischel, ibid., 866-868.

[56] Ibid., 868.

[57] H Manne, "Insider Trading and the Law Professors" (1970) 23 *Vanderbilt Law Review* 547, 574–575.

[58] Manne, above n 40, 101–102.

[59] See, *Schein v Chasen* 313 So 2d 739 (Fla1975).

[60] J D Cox, "An Outsider's Perspective of Insider Trading Regulation In Australia" (1990) 12 *Sydney Law Journal* 455, 457–8.

[61] See, M King and A Roell, "Insider Trading" (1988) April *Economic Policy* 163, 168 *et seq*.

suggested that regulating insider dealing is misconceived, since it cannot be effectively enforced.[62]

Interestingly, there are signs of a shift in the terms of the academic debate surrounding the merits of regulating insider dealing, spurred on, it would seem, by a quest for "hard facts". A review of the recent literature reveals that scholars have begun to move away from earlier exchanges rooted in clashes between competing theoretical viewpoints, towards a newer debate which today focuses on an empirical analysis of the effects of regulation and its enforcement.[63] Although this empirical debate has taken some time to get going,[64] and aspects of it suffer from recognised methodological weaknesses,[65] a body of empirical work has nevertheless begun to emerge that is broadly supportive of legal prohibitions on insider dealing on efficiency grounds.

Thus, for example, studies show that countries in which insider dealing is more prevalent have more volatile stock markets;[66] that the cost of a country's capital decreases significantly after its first insider dealing

[62] See, H Manne, "Insider Trading and Property Rights in New Information" (1985) 4 *Cato Journal* 933, 937.
[63] To some extent these developments are part of a burgeoning empirical law and finance literature (sparked by the pioneering work of R La Porta, F Lopez-de-Silanes, A Shleifer and R Vishny – see, eg, "Legal Determinants of External Finance" (1997) 52 *J Fin* 1131).
[64] L Beny, "Insider Trading Laws and Stock Markets Around the World: An Empirical Contribution to the Theoretical Law and Economics Debate" (2007) 32 *J Corp L* 237, 239.
[65] For a good review of these weaknesses, see, L Hughes, "Impact of Insider Trading Regulations on Stock Market Efficiency: A Critique of the Law and Economics Debate and a Cross-Country Comparison" (2009) 23(2) *Temple International & Comparative Law Journal*, 479–510.
[66] J Du and S Wei, "Does Insider Trading Raise Market Volatility?" (2004) 114 *Econ J* 916, 940.

prosecution,[67] and that analyst following increases after a country's initial enforcement of its insider dealing laws.[68] Studies also suggest that bid-ask spreads widen where market-makers are exposed to better informed traders;[69] and that stock prices reflect more firm specific information in jurisdictions with more stringent insider trading laws.[70] Finally, in Beny's influential 2007 comparative survey, "Insider Trading Laws and Stock Markets Around the World", the author finds that those countries with "more stringent insider trading laws are generally associated with more dispersed equity ownership, greater stock price accuracy and greater stock market liquidity."[71]

In an age where our ability to measure and test claims is better than ever before, an appeal to empiricism to resolve a previously inconclusive academic debate is, unsurprisingly, attractive.[72] Yet while the reconfiguration of the debate in empirical terms is undoubtedly of interest, such an inquiry is unlikely to shed much light on the important question of what our legal rules ought to be.[73] This is not because of a lack of reliable

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[67] U Bhattacharya and H Daouk, "The World Price of Insider Trading" (2002) 57 *J Fin* 75, 79 (2002).

[68] R Bushman, J Piotroski, and A Smith, "Insider Trading Restrictions and Analysts' Incentives to Follow Firms" (2005) 60 *J Fin* 35.

[69] L Glosten and L Harris, "Estimating the Components of the Bid/Ask Spread" (1988) 21 *J Fin Econ* 123, 140–141.

[70] N Fernandes and M Ferreira, "Insider Trading Laws and Stock Price Informativeness", (2009) 22 *Rev Fin Stud* 1845, 1880–1881.

[71] L Beny, above n 64. However, cf Beny, "Do Shareholders Value Insider Trading Laws? International Evidence" (August 2006) (http://deepblue.lib.umich.edu/bitstream/handle/2027.42/57217/wp837%20.pdf?sequence=1) 11 (claiming that more stringent insider trading laws are associated with higher corporate valuation in common law countries, but lower corporate valuation in civil law countries).

[72] *See* Carlton & Fischel, above n 41, 866.

[73] See, eg, J Rachlinski, "Evidence-Based Law" (2011) 96 *Cornell L Rev* 901, 918; and Shai Woznert, "Evidence-Based Law by Jeffrey J Rachlinski" (2011) 96 *Cornell L Rev*

data, problematic though this is; but rather because the "market tools" used to conduct this empirical analysis – and the conclusions derived from this body of work – rest on a priori assumptions about the nature of markets which are, themselves, not capable of being resolved by empirical analysis.

Thus, for example, standard neoclassical accounts of the operation of the market mechanism stipulate that for markets to deliver optimal societal outcomes, no informational asymmetries should exist – that is to say, conditions must exist which enable each party to make rational decisions based on "full" or "perfect" information. Where such conditions do not hold, there is said to exist a market failure which provides a prima facie justification for state intervention to remedy the failure. In relation to informational asymmetries, determining where the exact boundaries of any given market failure lies, tends either to be glossed over, or regarded as self-evident. Yet to suppose that the debate about whether a particular informational advantage should or should not be used in a given set of market transactions is, in fact, capable of being resolved by the use of studies testing the efficiency or otherwise of that market is misconceived, since the underlying problem can only be addressed by an appeal to non-market values which are themselves beyond the realm of empirical observation. As Justice Allen informs us, although "[e]mpiricism is of great instrumental utility in the law, as a way of informing us how best to achieve some noncontroversial value .... disputes of ultimate value cannot be resolved by empirical investigations."[74] Carlton and Fischel's claim, noted above, that the "desirability of regulating insider trading is ultimately

925. However, such considerations have not prevented commentators from continuing to couch debate in these terms: see, eg, Hughes, above 65, 484.
[74] Allen, above n 44, 183, fn 22.

an empirical question"[75] is therefore misguided, and Beny's enthusiastic appeal for "more empirical work … to conclusively resolve the theoretical debate"[76] little more than a chimera.

IV. THE EVOLVING REGULATORY LANDSCAPE

Notwithstanding the contested nature of the various rationales offered in support of prohibitions on insider dealing (and to a lesser extent market manipulation), there nevertheless exists a widespread global consensus about the need for measures outlawing such conduct.[77] In this respect, developments within the EU offer an excellent vantage point from which to survey the evolving regulatory landscape – both general, and in terms of the regulatory response to recent market integrity concerns prompted by allegation of abusive short selling in the aftermath of the financial crisis, benchmark manipulation, the growing lack of transparency associated with the fragmentation of markets and trading platforms, and the heightened scope for abusive practices associated with the increasing use of HFT strategies. What is more, the EU regime also provides an interesting and increasingly important counterpoint to the US approach to insider dealing in particular.

The EU Market Abuse Regime

Unlike the US regime – the broad contours of which are outlined below – the EU regime on insider dealing rejects any need for a showing of fraud or

[75] Above n 42, 866.
[76] Benny, above n 71, 241.
[77] In a study of conducted by Bhattacharya and Daouk, as of the end of 1998 of the 103 countries that had stock markets, 87 had laws prohibiting insider dealing: Bhattacharya and Daouk, above n 67, 75.

deception based on a breach of fiduciary duty (or other similar relationship of trust and confidence). Instead, the EU regime – in keeping with a global trend of which it might claim to be an exemplar – is predicated on an underlying policy of regulating market relationships by prohibiting persons from trading on the basis of non-publically available information.[78] The regime is given legal expression by way of the Market Abuse Directive (MAD)[79] – a key directive in a broader phalanx of measures designed to promote the development of a pan EU capital market – which embodies "bright line" minimum legislative standards, duly implemented in each EU Member State.

In essence, the EU's market abuse regime, which prohibits both insider dealing and market manipulation (collectively, known as "market abuse"), is characterised by complex statutory rules which marry technical proscriptions with detailed statutory exemptions,[80] defences, and safe harbours.[81] Accordingly MAD specifies the key ingredients of each market abuse offence. Thus, in relation to insider dealing, it specifies: the categories of person covered (eg primary and secondary insiders);[82] the nature of the conduct proscribed (eg dealing, disclosing, and

[78] MAD is designed to support the integrity of financial markets by helping to promote public confidence in, and the smooth function of, those markets: Recital 2.
[79] The European Union's market abuse regime is currently comprised of (a) a framework directive called the Market Abuse Directive (MAD) (Directive 2003/6/2003; and (b) three European Commission directives: (i) the Market Manipulation Definitions Directive (Commission Directive 2003/124/2003); (ii) the MAD Implementing Directive (Commission Directive 2003/125/2003; and (iii) the Market Practices and Disclosure Directive (Commission Directive 2004/72/2003); as well as a Commission Regulation called the MAD Implementing Regulation (Commission Regulation 2273/2003).
[80] MAD, Art 7.
[81] MAD, Art 8, on stablisation and buy-backs.
[82] MAD, Arts 2 and 4.

recommending);[83] the type of securities caught (eg equities, debt, derivatives etc);[84] the range of public markets to which the prohibition extends ("regulated markets");[85] the nature of the information on which dealing etc is prohibited ("inside information");[86] and the regime's jurisdictional reach.[87]

The EU's market abuse regime (unlike the position in the US) also embodies a commitment to the continuous disclosure of material information which is designed to promote the timely disclosure of material information, and thus limit the scope for insider dealing ex ante. The regime further comprises the use of "insider lists" (and insider reporting of certain personal transaction), as well as the reporting of suspicious transactions. Although MAD is non-prescriptive with regard to the type of sanctions required, as discussed below, a key feature of forthcoming EU reforms is the introduction of a more uniform and muscular approach to the use of sanctions and, indeed, to enforcement issues generally.

As an ambitious and mutli-faceted regime with a broad compass, MAD represents a marked improvement on earlier harmonisation efforts in the area, and can fairly be regarded as a qualified success. Nevertheless, the regime has also had to face a number of significant challenges. For example, events associated with, and in the aftermath of, the recent

[83] MAD, Arts, 2 and 3.
[84] These include "transferrable securities" as widely defined by, Markets in Financial Instruments Directive (MiFID) Directive 2004/39/EC: Art 4(1)(18).
[85] See, MiFID Art 4(1)(14). Although a trading market may elect not to be a "regulated market", as a mimum standards directive, Members States may enact laws which go above and beyond the EU minimum – ie "gold plate". The EU regime also extends beyond regulated markets, encompassing trades on other markets where there is a causal connection with the operation of a regulated market.
[86] MAD, Art 1.
[87] MAD, Art 10.

financial crisis (namely, abusive short selling and benchmark manipulation), and the growing spectre of abuse associated with the growth of HFT strategies, have sorely tested the credibility of the regime and brought into sharper focus its ability to respond effectively to an ever expanding range of market integrity concerns. Accompanying these recent challenges are more long-standing problems associated with the lack of transparency resulting from the increasing fragmentation of trading venues in the wake of MiFID, and the more general lack of a coordinated pan European approach to the use of sanctions and enforcement in relation to breaches of the regime.

The EU's response to these challenges has been nuanced and multi-layered, involving a combination of: targeted measures, "soft law" guidelines, and amendments to associated Directives; as well as the outright overhaul of the market abuse regime itself. Thus, in relation to allegations of "abusive" short selling in the aftermath of the crisis, while it was generally accepted that such conduct would, in principle, amount to market abuse under MAD, it was nevertheless felt that more general concerns surrounding short selling were better dealt with by way of a targeted measure (the "Short Selling Regulation") rooted in disclosure and improved market transparency.

In relation to the spectre of abuse associated with the use of certain HFT strategies, the European Securities and Markets Authority (ESMA) – the EU's sectoral regulator responsible for securities markets – has issued "soft law" guidelines.[88] These guidelines aim to ensure that regulated markets and multi-lateral trading platforms (MTFs) have in place arrangements which enable them to identify conduct amounting to market abuse in an

[88] Above n 24.

automated trading environment,[89] and that investment firms which engage in algorithmic trading (with which HFT is strongly associated) have organisational arrangements in place to "to minimise the risk that their automated trading activity gives rise to market abuse (in particular market manipulation)".[90] ESMA's soft law guidelines are in turn supplemented by amendments to the MiFID framework by way of a revised MiFID Directive (MiFID II)[91] and a new Regulation (MiFIR)[92] which place a number of restrictions on algorithmic trading, such as specific organisational requirements for firms engaging in algorithmic trading (and, more pertinently, in respect of market making algorithms) as well as measures targeted specifically at HFT participants, including fee structures for excessive order cancellation and minimum tick sizes.[93]

As far as the overhaul and upgrade of MAD itself is concerned, the Commission has chosen two legal mechanisms: a Regulation (the Market Abuse Regulation (MAR)), which is directly applicable in each Member State, designed to reduce regulatory complexity and to promote great legal certainty; and a new Directive (Directive on criminal sanctions for insider dealing an market manipulation (CS-MAD))[94], which requires the creation of criminal offences for serious forms of market abuse. Although recent events associated with concerns about short selling, benchmark manipulation, and the growth of HFT strategies, have added momentum to the reform of MAD, the rationale for the new regime is, in fact, rather more long standing. For reasons of space, I focus only on two key areas

[89] Ibid., Guideline 5.
[90] Ibid., Guideline 6.
[91] http://register.consilium.europa.eu/doc/srv?l=EN&f=PE%2023%202014%20INIT.
[92] http://register.consilium.europa.eu/doc/srv?l=EN&f=PE%2022%202014%20INIT
[93] It is not expected that MiFID II or MiFIR will come into effect until late 2016 or early 2017.
[94] http://db.eurocrim.org/db/en/doc/2023.pdf

which, while broad brush, nevertheless offer a sense of the "general direction of travel" and resonate with at least some of the broader them themes touched on earlier – principally the willingness of modern securities regulators to flex their regulatory muscles by expanding the scope of the regimes they regulate, and their increasing willingness to resort to use of criminal sanctions to police those regimes. The two areas I focus on in this respect are: (i) efforts to remedy perceived gaps in the scope of the existing EU regime; and (ii) efforts to remedy perceived enforcement deficiencies in that regime.

(i) Remedying Perceived Gaps in MAD

Notwithstanding the broad scope of the EU's existing market abuse regime, in the light of both market and regulatory developments a number of gaps in the regime have been identified, which MAR seeks to address. Currently MAD only prohibits market abuse in relation to financial instruments which are admitted to trading on a regulated market, whereas following the reforms introduced by MiFID, increasingly financial instruments are being traded on multilateral trading facilities (MTFs), on organised trading facilities (OTFs), or on over the counter (OTC) markets. Accordingly, MAR seeks to broaden the scope of the EU's regime by including any financial instrument traded on an MTF (or admitted to trading on such a platform, or for which a request for admission to trade on a MTF has been made), or an instrument traded on an OTF, as well as any related financial instruments traded OTC (such as credit default swaps (CDS)) which can have an effect on the covered underlying market. In this way, MAR is designed to bring the definition of financial instruments used in the context of market abuse into line with that used in MiFID and thus remedy a widely acknowledged mismatch between the two regimes.

MAR also seeks to widen the scope of the existing regime by a series of other reforms, namely:

- extending the definition of inside information for commodity derivatives to encompass all information of a precise nature which is likely to have a significant effect on the price of, and is relevant to, either the related spot commodity contract or the derivative itself (and where this is information which is reasonably expected to be disclosed or required to be disclosed in accordance with relevant legal or regulatory provisions);[95]
- extending the definition of market manipulation to encompass "cross market manipulations" – for example, transactions in derivatives markets designed to manipulate the price of related spot markets and vice-versa;[96]
- classifying emission allowances as financial instruments and inserting a specific definition of inside information in relation to such instruments;[97]
- expanding the scope of market manipulation to cover activities associated with benchmarks (such as LIBOR and EURIBOR);[98]
- providing an indicative list of practices associated with algorithmic trading and HFT strategies which will be regarded as species of market manipulation;[99]

[95] MAR, Art 7.
[96] MAR, Art 12.
[97] MAR, Art 2.
[98] MAR, Art 2.
[99] MAR, Art 12, Annex I.

- introducing specific offences of attempted insider dealing and attempted market manipulation;[100] and
- extending the current obligation to report suspicious transactions to the reporting of suspicious unexecuted order and suspicious OTC transactions.[101]

These reforms a reveal a commitment by the EU to review and reform the contours of its market abuse regime in the light of developments in market infrastructure []

(ii) Remedying Enforcement Problems:

As well as seeking to remedy gaps in the MAD regime, the Commission's reforms also aim to remedy acknowledged weaknesses in the way in which the regime is enforced. Under MAD, Member States have adopted a variegated approach to sanctions which has undermined the development of a fully integrated market.[102] The aim of the new reforms, therefore, is to introduce more uniform pan EU enforcement measures which will have greater deterrent effect. These measures combine the introduction of new investigative powers for national regulators (so as to help detect market abuse), and the introduction of a new system of sanctions. These sanctions comprise the use of new administrative penalties (set out in MAR), as well as the use of criminal measures (set out in the CS-MAD) designed to

[100] MAR, Arts 14 and 15.
[101] MAR, Recital 46 and Art 16.
[102] Overall, the picture of Member States' regimes is "weak and heterogeneous". *Report of the High Level Group on Financial Supervision in the EU* (February 2009)(the *De Larosiere Report*) para 84 <http://ec.europa.eu/economy_finance/publications/publication14527_en.pdf>.

demonstrate a degree of "social disapproval [which is] qualitatively different" from the use of administrative or compensatory measures.[103]

In relation to administrative sanctions, MAR establishes that the maximum administrative fine should be three times the profits gained or losses avoided in so far as these are ascertainable.[104] For natural and legal persons administrative penalties vary. For the offences of insider dealing and market manipulation, natural persons are subject to a fine of at least €5 million (for legal persons this is at least €15 million (or 15% of the entity's annual turnover)), and, for the remaining offences under MAR, fines ranging between €1 million and €500,000 depending on the exact nature of the offence (for a legal person this ranges between at least €2.5 million (or 2% of total annual turnover) and €1 million). Member States do, however, have a discretion to exceed these limits.

When imposing sanctions, competent authorities are under an obligation to take account of any aggravating factors (such as the gravity of the offence committed), or any mitigating factors (such as an offender's cooperation with an investigation).[105] Where persons commit repeated breaches of the offences of insider dealing and market manipulation, competent authorities may prohibit any such persons from discharging or exercising managerial responsibilities in an investment firm.[106]

In relation to criminal sanctions, since, in accordance with EU law, the approximation of criminal law is only possible by way of a directive, these

[103] CS-MAD, Recital 6.
[104] MAR, Art 30.
[105] MAR, Art 31.
[106] MAR, Art 30.

are dealt with by way of CS-MAD.[107] In short, this requires the creation of criminal offences for serious forms of market abuse. Thus, under CS-MAD, Member States are required to treat serious cases of intentional insider dealing and market manipulation (as well conduct which amounts to inciting or aiding and abetting those offences), and attempted insider dealing and attempted market manipulation, as criminal offences. Legal entities must be rendered subject to sanctions, as well as any individuals directly responsible for the misconduct.[108] Sanctions must be "effective, proportionate and dissuasive".[109] For individuals, the maximum sanction is at least four years' imprisonment for market manipulation and insider dealing (and recommending or inducing another person to engage in insider dealing), and two years' for the unlawful disclosure of inside information.[110] For legal persons, sanctions can comprise criminal or non-criminal sanctions.[111] In relation to the latter, these may include fines and sanctions such as: exclusion from entitlement to public benefits or aid; temporary or permanent disqualification from carrying on commercial activities; judicial winding up; or temporary or permanent closure of establishments which have been used in the commission of the offence.[112] Again, Member States retain a discretion to adopt or maintain more stringent criminal law measures.

[107] Under the Lisbon Treaty, the UK is not automatically bound by EU legislative proposals in relation to freedom, security, and justice matters. The UK has chosen not to opt into CS-MAD, albeit that it retains the right to do so.
[108] Legal entities will be liable for a criminal offence if it is committed for their benefit by a person holding a leading position in the firm: Art 7(1) CS-MAD. Moreover, companies may also be criminal liable for offences committed by junior employees for the company's benefit where there has been a corporate failure (eg where there has been a lack of supervision and control over that person by senior management): Art 7(2).
[109] CS-MAD, Art 6.
[110] CS-MAD, Art 6.
[111] CS-MAD, Art 8.
[112] CS-MAD, Art 8.

In sum, while there is much about the EU's enforcement of it market abuse regime which is likely to remain problematic notwithstanding these reforms, this more muscular approach to enforcement is both timely and welcome – and to a large extent resonates with developments in a number of other jurisdictions, namely the US and the UK.

The US Approach to Insider Dealing

The EU approach discussed above – at least in relation to insider dealing – stands in stark contrast to the US's long-standing regulatory approach. In what can be regarded as an increasingly anomalous position, US insider dealing laws remains wedded to what is essentially a 'relationship based' model emphasising the protection of fiduciary norms of trust and confidence between parties, the classic example of which is the corporate insider who misappropriates company property (inside information) for personal benefit at the expense of his or her company. Lacking in an over-arching legislative definition, the origins of US law on insider dealing instead lie in the development of a somewhat *ad hoc* corpus of law derived from: (a) s 10(b) of the Securities Exchange Act 1934 (a broad anti-fraud provision rendering it unlawful for any person to employ in connection with the purchase or sale of any security "any manipulative or deceptive device or contrivance" in contravention of SEC rules); and (b) the now notorious Rule 10b-5 promulgated thereunder.[113]

[113] Rule 10b-5, which was not adopted by the SEC until 1942, states that:
"It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
(1) to employ any device, scheme, or artifice to defraud,
(2) to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

Accordingly, both SEC administrative rulings and judicial decisions have played a highly significant role in shaping many of the elements of what constitutes insider trading,[114] in a manner "reminiscent of a common law approach."[115] Bereft of the more consciously drawn contours of other modern regimes – such as illustrated by the position in the EU – a view has long been expressed that US insider trading jurisprudence is beset by "considerable ambiguity"[116] and "undermined by the absence of a definition".[117] Although at various times during the 1980s Congress considered legislative proposals for a statutory reformulation of the test for "insider trading", the argument that a statutory definition could "unintentionally narrow the scope of the law by facilitating schemes to evade the law"[118] has ultimately prevailed.

The absence of a broad statutory definition does, admittedly, afford the US authorities some discretion over how to respond to insider dealing threats, and in many respects US law has proved itself capable of evolving to meet

(3) to engage in any act, practice, or course of business which operates or would operate as fraud or deceit upon any person, in connection with the purchase or sale of any security."

[114] For example, the meaning of "non-public inside information", as well as the degree of *scienter* (*mens rea*) required to generate liability under section 10(b) and Rule l0b-5.

[115] E Greene and O Schmid, "Duty-Free Insider Trading?" [2013] *Columbia Business Law Review* 369, 372.

[116] H Pitt and K Shapiro, "The Insider Trading Proscriptions Act of 1987: A Legislative Initiative for a Sorely Needed Clarification of the Law Against Insider Trading" (1988) 39 *Ala L Rev* 415, 417.

[117] L Ruiz, "European Community Directive on Insider Dealing: A Model for Effective Enforcement of Prohibitions on Insider Trading in International Securities Markets" (1995) *33 Colum J Transnat'l L. 217* .

[118] Insider Trading and Securities Fraud Act of 1988, HR Rep. No. 100-910, 100th Cong, 2d Sess, § 3 (1988). The Insider Trading Sanctions Act of 1983, Hearings before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs, 98th Cong, 2d Sess 37 (1984) (statement byJ Fedders, former SEC Enforcement Division Director).

market needs. In the aftermath of the SEC's set-back in *Chiarella*,[119] and, again, not long thereafter in *Dirks*,[120] the general trajectory of US insider dealing law has been undeniably expansionary – achieved in part by way of the Supreme Court's subsequent endorsement of the "misappropriation theory" in *O'Hagan*,[121] and also by way of detailed SEC rule-making (often as a means of countering judicial rebuffs).[122] Nevertheless, in being primarily tethered to its "breach of duty" moorings as the basis for a showing of deceptive conduct under s10b and Rule 10b-5, the development of US law has, arguably, been hindered by its weak foundations. These foundations have given rise to a jurisprudence which is deficient in terms of its conceptual underpinnings (focusing on an overly narrow breach of duty as the basis of deceptive conduct rather than a more broadly based concept involving the regulation of market relationships),[123] under-inclusive in terms of its scope (there have recently been a number of cases where the courts have declined to rule that conduct was in breach of

[119] 445 US 222 (1980). Here, the Supreme Court held that the duty to "disclose or abstain" – derived from its earlier ruling in *Texas Gulf Sulphur* 401 F 2d 833 (2d Cir 1968) – was dependent upon whether the defendant owed the issuer of the securities a fiduciary *or other relationship of trust and confidence*. The Supreme Court found that no such relationship existed. Accordingly, since no duty was owed to the issuer, the defendant was free to trade in the issuers securities on the basis of the material information he possessed.

[120] *Dirks v SEC* 463 US 646 (1983).

[121] *United States v O'Hagan*, 521 US 642, 653-54 (1997). The misappropriation theory holds that a person is prohibited from trading on the basis of information which has been misappropriated from its source, irrespective of whether the source of the information is a corporate (or temporary) insider of the issuer in whose securities trading has taken place. Accordingly, while no breach of fiduciary duty by a corporate (or temporary insider) is required to establish liability under the misappropriation theory, a fiduciary or similar duty of trust or confidence to the source of the information must nevertheless be established.

[122] For example, the SEC immediately followed its set-back in *Chiarella*, with the promulgation of Rule 14e-3, made pursuant to s 14 (e) SEA 34 (prohibiting insider dealing in the context of takeovers). The rule applies irrespective of whether the defendant owes or has breached a fiduciary or other duty to the relevant issuer.

[123]

Rule 10b-5),[124] and clumsy and erratic in terms of its ad hoc development (evident by virtue of an element of "ebb and flow" in legal developments).

More generally, at a time when financial markets are more global and inter-connected than ever before, the US approach to the development of its corpus of its insider dealing law is increasingly out of step with other major financial centres, particularly in the UK and in continental Europe. Although the EU regime has much to learn from the US in terms of the latter's long-standing commitment to active enforcement, it is suggested that the US could learn much from the more comprehensive and systematized "bright line" approach evident in the EU regime. Indeed, recent efforts to upgrade the EU's market abuse regime, both in terms of its scope and by way of a more muscular approach to enforcement issues – in particular, by way of the endorsement of the use of criminal sanctions for serious market abuses – presages a new era for EU regulation of such conduct. More significantly, forthcoming reforms place the EU at the vanguard of the global charge to tackle market abuse, and, once implemented, mean that the EU regime can fairly lay claim to being the most comprehensive and sophisticated market abuse regime in the world.

To some extent, the EU's new approach to the use of criminal sanctions resonates with a global trend towards more intensive enforcement of market abuses and, more especially, the use in some quarters of criminal sanctions to deter insider dealing, as discussed below in Section V.

[124] See, eg, J Coffee, "Introduction: Mapping the Future of Insider Trading Law: of Boundaries, Gaps, and Strategies" (2013) *Colum Bus L Rev* 281, 289–296 (discussing recent case law). See also, S Bainbridge, "An Overview of Insider Trading Law and Policy: An Introduction to The Insider Trading Research Handbook" in Bainbridge (ed) *Research Handbook on Insider Trading* (Edward Elgar Publishing Ltd, 2013) 1, 2 (the existing law is characterised by "a number of problems and curious gaps").

V. ENFORCEMENT TRENDS

A notable feature of the insider dealing debate over the last 40 years or so, has been a disjuncture been the eagerness of countries to enact laws prohibiting insider dealing, and their subsequent unwillingness/inability to enforce those laws. Significantly, evidence is now emerging which suggests that this global picture is slowly beginning to change. According to Clark, from 2009 to the end of March 2010, a number of countries across five continents reported increased levels of insider trading enforcement: Australia, Canada, Italy, China, and Kenya.[125] Furthermore, evidence of significant enforcement developments have also been reported in Hong Kong,[126] Japan,[127] Singapore,[128] France,[129] Germany,[130] and the UK.[131] And in a number of other jurisdictions, regulators have confirmed that the

[125] See S Clark, "Insider Trading and Financial Economics: Where Do We Go From Here?" (2010–2011) 16 *Stan J L Bus & Fin* 43 and sources cited therein. See also, Madison Marriage, "Red alert over record year for insider dealing" *Financial Times* (5 January, 2014) (http://www.ft.com/cms/s/0/b426dc10-7461-11e3-9125-00144feabdc0.html#axzz2qvY7edpj).

[126] See, K Wong, "Former Morgan Stanley Banker Du Jailed for 7 Years" *Bloomberg* (18 September, 2009) (*available at* http//www.bloomberg.com/apps/news?pid--newsarchive &sid=aZcWlQ2OIrfY).

[127] Morrison Foerster, *Insider Trading: Annual Review* (http://www.mofo.com/files/Uploads/Images/130116-Insider-Trading-Annual-Review.pdf).

[128] Ibid.

[129] In France, insider dealing fines more than doubled to €19m in 2013. Marriage, above n 123.

[130] In 2013, investigations into insider dealing increased from 26 to 42. *Ibid*.

[131] See below n ? and accompanying text.

enforcement of their insider dealing/market abuse laws represents a major priority going forward.[132]

Not surprisingly, the US authorities (primarily, the SEC and the Department of Justice (DoJ)) remain at the forefront of efforts to enforce insider trading laws. According to a recent study by Beny and Seyhun, the authors found that while from 1980 through to the late 1990s, there was a steady, albeit rather modest year on year increase in the number of actions brought by the SEC for insider dealing, thereafter there was a "fundamental turning point" in the Agency's enforcement intensity.[133] Thus, between 1980 and 1990, SEC actions almost doubled (from 20 to 38), and between 2005-2010 (following a marked increase from 2000 onwards) they remained relatively steady, at an average of 49 actions per year.[134] The authors also found signs of renewed enforcement intensity in 2010-2011, with the SEC reporting 57 insider dealing actions against 124 individuals and entities, an increase of nearly 8% in the number of actions filed by them from the previous fiscal year.[135]

Although Beny and Seyhun adduce only anecdotal evidence to support their claim that there has also been an increase in the number of criminal convictions for insider dealing, they nevertheless show that where

[132] See, for example, the Dutch Authority for Financial Markets, the Autoriteit Financiële Markten (AFM) (Freshfields Bruckhaus Deringer, *European Market Abuse News* (Spring 2012)); and, in Spain, the Securities Markets Commission (CNMV) (Freshfields Bruckhaus Deringer, *Global Market Abuse News* (Spring 2013)).

[133] L Beny and N Seyhun, above n 28, 000 (finding that between 1980 and 1990, actions almost doubled (to 38), and that between 2005–2010 they have remained relavtively steady, at an average of 49 actions per year).

[134] The number of SEC investigations into insider dealing has also recently increased in 2013. Marriage, above n 123.

[135] In 2012, the SEC also settled 118 cases of insider dealing, significantly more that the previous 6 year average of 71: Freshfields Bruckhaus Deringer (2013), above n 130.

convictions have occurred, the severity of punishment has increased.[136] Between 1993 and 1999, fewer than 5% of defendants received custodial sentences of two years or more, whereas between 2000 and 2009 this had increased to more than 25%. Moreover, reflecting the type of renewed SEC enforcement intensity referred to above, in the last two years this has doubled, to around 50%.[137]

To some extent echoing US developments, evidence of a renewed commitment to enforcing insider dealing and wider market abuse laws can also be found in the UK.[138] Here a policy of "credible deterrence" – pioneered by the now defunct FSA, and today continued by the newly formed Financial Conduct Authority (FCA) – has been carried out with considerable vigour.[139] As part of this policy, the UK regulator has proved willing to use the full array of enforcement tools at its disposal,[140] including a willingness to bring criminal charges against individuals.[141] Thus, having not commenced its first criminal prosecution for insider dealing until 2008,

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[136] Beny and Seyhun, above n 28, 000, (finding that the probability of serving a prison sentence as well as the length served significantly increased).

[137] Emblematic of US successes on this front is the recent high profile conviction of Raj Rajaratnam, a former hedge fund manager, who was sentenced to eleven years' imprisonment and fined over $156 million. Furthermore, in March 2013, the SEC announced a record $602m settlement on insider dealing charges against the hedge fund advisory firm, CR Intrinsic Investors (CR), as well as a $14m settlement with its affiliate, SAC Capital Advisors.

[138] In the UK the criminal offence of insider dealing is governed by the Criminal Justice Act (Part V) 1993, whereas the civil/administrative offence of market abuse is governed by the Financial Services and Markets Act Part VIII.

[139] This policy was first introduced in its 2008/2009 Business Plan by Hector Sants (the then CEO of the FSA).

[140] In relation to market abuse under FSMA 2000, Part VIII, these encompass: public censure (s 123(3)); the imposition of a fine ((s 123(2); and, on its own initiative, restitution against an *authorised person* (s 384). The FCA may also apply to the court for: (a) injunctions (s 381(1)); (b) remedial orders (s 381(2)); (c) freezing orders (s 381(3)); and (d) restitutionary and compensatory orders (s 383).

[141] Unlike the SEC in the US, the FCA is vested with authority to prosecute breaches of the CJA (Part V) 1993: FSMA 2000, s 402(1)(a)).

the FSA had, by July 2013, secured 23 successful convictions.[142] Recent figures confirm that this trend has not abated, with a further 7 criminal prosecutions pending. Furthermore, there is evidence to suggest that at the time of its demise, the FSA was both willing and able to investigate and prosecute more complex cases and that an increasing number of defendants were sufficiently cowered to plead guilty to insider dealing charges.[143] To some extent, evidence of the UK's recent focus on the use of criminal sanctions for breaches of its insider dealing laws also resonates with indications of a more muscular approach by the EU in relation to sanctions, as noted above.

A number of factors are likely to underpin this global trend towards more active enforcement of insider dealing laws.[144] First, since markets in which insider dealing is perceived to be rife are likely to be regarded as less attractive centres for cross-border trading, regulators have an incentive to enforcement laws in the hope of attracting more cross-border deals. Secondly, greater emphasis on enforcement may reflect a market's evolving understanding of conduct which adversely affects market integrity. Thus a nation's response to enforcing, say, insider dealing violations may, in fact, be emblematic of, and a useful proxy for, the maturity of its financial markets – if not always the quality of its regulatory regime overall. Thirdly, following IOSCO's lead, scope for lead greater

[142] http://www.fca.org.uk/news/firms/four-arrested-in-fca-insider-dealing-investigation.
[143] Such as the successful conclusion of "Operation Saturn", involving convictions against an insider dealing ring trading multiple stocks between 2006 and 2008. FSA, *Annual Report 2012/13*, 39.
[144] See H Pitt and D Hardison, "Games without Frontiers: Trends in the International Response to Insider Trading" (1992) 55 *Law & Contemp Probs* 199 (explaining a similar albeit less pronounced trend in the late 1980s and early 1990s – at least in relation to the enactment of insider dealing laws).

investigative assistance and mutual cooperation amongst foreign securities authorities is likely to enhance enforcement efforts.[145] Thirdly, use of increasingly sophisticated surveillance techniques has increased regulators' chances of detecting unusual trading patterns, and thus helped to increase the number of investigations and, subsequently, the number of enforcement actions they are able to bring.[146]

A final and less benign reason for the observed increase in enforcement intensity might reside in the idea that some regulatory regard more vigorous enforcement of conduct such as insider dealing, as a relatively easy and high-profile way of re-asserting authority over both their financial markets and the "actors" they regulate. This is likely to be particularly so insofar as regulatory authorities have been the focus of sustained criticism in relation to their performance in the lead up to, and during, the financial crisis. Obvious candidates in this context are the regulatory authorities in both the US and the UK – two jurisdictions which are currently at the forefront of the enforcement charge.

V. CONCLUSION

[145] IOSCO, *Multilateral Memorandum Of Understanding: Concerning Consultation And Cooperationand The Exchange Of Information* (http://www.bcsc.bc.ca/uploadedFiles/IOSCO_MMOU_2012.pdf).

[146] For example, for developments in the UK, see, R Sullivan "FSA unveils new market abuse detector" (7 August, 2011) (http://www.ft.com/cms/s/0/76f6adee-bea5-11e0-ab21-00144feabdc0.html#axzz2qvY7edpj) (detailing the introduction of Zen); and in Australia (M Drummond, "ASIC targets insider traders with new $44m surveillance system" *Financial Review* (24 Nov, 2013) (http://www.afr.com/p/business/sunday/asic_targets_insider_traders_with_UbmmHE8v9cFZaGDfir6QGO) (detailing the introduction of a new surveillance system called 'MAI').

In the aftermath of the global financial crisis there has been renewed interest in, and more intense scrutiny of, activities which raise the spectre of market abuse and in turn prompt concerns about market integrity. Such evidence as exists, suggests that market abuse is a continuing problem in the context of modern financial markets and that it poses acute challenges for regulatory authorities. As both markets and trading strategies continue to evolve, new strains of market abuse have emerged and opportunities for abuse now exist on a scale not previously possible.

Although market manipulation, and especially abusive conduct associated with HFT, is increasingly attracting the gaze of regulators, much academic and regulatory attention continues to focus on insider dealing – a practice long regarded as emblematic of our concerns about market integrity. In the space of only a handful of decades, insider dealing has gone from being a distinctly US preoccupation, to a practice which today attracts global opprobrium. In Europe, which, by virtue of MAD, has been the testing ground for pan EU measures prohibiting insider dealing and market manipulation – and for the deployment of continuous disclosure measures which seeks to prevent abuse ex ante – the regulatory landscape is both complex and evolving. Although long in the shadow of US efforts to promote market integrity, the MAD regime has enabled the EU to emerge as a global player in the fight against market abuse. What is more, forthcoming reforms which are set to widen the regime's scope, combined with a more muscular approach to the enforcement of it, threaten to catapult the EU's regime to the very forefront of global efforts to "keep markets clean".

Ultimately, however, assessing where the right balance is between permitting certain informational advantages and market practices and outlawing others so as to support and promote market integrity, raises fundamental questions about the nature of those markets, and the conditions necessary for the claimed benefits of market optimality to materialise. Properly understood, financial markets represent socially constructed mechanisms which are designed to harness human energies (and allocate scare resources) for productive, collectively enriching, purposes. Accordingly, the decision to prohibit insider dealing, and market abuse more generally, turns on a determination of those conditions upon which private investment in the pursuit of private profit on public markets is rendered legitimate. And in order to do this, not only do we need to work out what sort of initiative we wish to encourage/discourage but, more broadly, what we value as a society. For these reasons, debates about market integrity – and insider dealing in particular – will, irrespective of the search for empirical resolution, forever remain fuzzy, messy and contestable.[147]

[147] See, Allen, above n 44, 176, 182.